Preliminary Notes on Offshore Financial Services: Prerequisites, Efficiencies, Risk Factors, and Business Outlook

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I. Introduction

Mostly international financial services are relatively big business not just for some very small functional offshore financial centers (OFCs).[1] Kaufman (2000, p. 6) cites an estimate that 7 percent of British GDP around 1998 was brought forth within one square mile of what is know as "the city" by 1 million employees, indirect employment included. In Luxembourg financial services in 2003 accounted for 30 percent of gross value added (see von Furstenberg, 2007) not counting ancillary services such as legal and accounting and tourism. Figures for Hong Kong and Singapore may be similar. Hence there are several countries and jurisdictions of appreciable size which make supplying international financial services one of their most important, and often subsidized, businesses. Because value-added per employee tends to be high, the direct local employment effects, as Lessard and Tschoegl (1988) have estimated, may be relatively small.

This paper seeks to explore what are the benefits and costs of promoting the main lines of the international financial service business and what is required to attract them to a particular location and to keep them there. It also considers how developments in financial technology and communications that affect the operation of capital markets and the need for relationship banking may affect the outlook for offshore financial services.

II. Requirements for Operation of Offshore and International Financial Service Centers

Lists of these requirements often have included libertarian criteria such as political independence of such centers from the government and a free market and private enterprise

environment (see, for instance, Kaufman, 2000, p. 15). However such centers often look to their Financial Services Authority to be a facilitator and promoter of their international financial business, rather than a mere supervisor. They also look to their government for business subsidies and preferences of various kinds and not just for prudential regulation to level the playing field and to protect depositors and investors. Indeed Offshore Financial Centers (OFCs) and International Financial Service Centers (IFSCs) often have been planned as part of an industrial development policy by national or subnational units of government. Hence the private enterprises engaged in international financial business are not always far removed from their government or its supportive "interference" and shields against disclosure, even when they are a thorn in the side of foreign governments. Hence principled libertarianism is not what such centers generally seek or practice.

There are however a number of fairly universal requirements for OFC/IFSC success that have been enumerated by Kaufman (2000, p. 15), Park, Ito and Wang (2005, p. 9), Bossone, Honohan, and Long (2005, p. 122), and others. In Table 1 these are divided crudely into macroeconomic prerequisites, infrastructure and human-capital requirements, and industry prerequisites. Falling short of meeting just a few of these criteria may be fatal to countries' growing a legitimate all-round international financial service business.

III. Fiscal Costs of the Offshore Financial Business

The list of government measures to establish and grow international financial service centers (IFSCs) is long and varied. The general practice is to tax very sparingly, if at all, income earned from international financial service business either by those conducting it or by nonresident entities financing it through their deposits, investments, and loans. For instance,

withholding taxes are generally not imposed on the interest income of such entities. Outright discrimination in favor of offshore over onshore activities is common and pervasive as, for instance, when the tax on bank profits from the Asian-Currency Unit (ACU), but not the Domestic-Banking Unit (DBU) of Singapore banks was cut from 40 to 10 percent in 1970 (Jin, 2005, p. 211). Such discrimination is also involved when expatriates employed in the international financial service business receive generous tax-free allowances in Hong Kong, or when those who have been accorded "enhanced fund manager" status in Singapore enjoy a complete tax holiday on fee income from providing investment management and advisory services to foreign investors (Jin, 2005, p. 222). Where there are value-added taxes as in Ireland, the international financial business may be exempt.

Pump-priming of lines of the financial business that are to be drawn to a particular location is also common. The Monetary Authority of Singapore and the Government of Singapore Investment Corporation, for instance, have placed $35 billion with managers in the private sector to encourage the growth of the fund management industry (Ito, Park, and Wang, 2005, p. 9). In addition, the government provides almost one fifth of the venture capital funding made available in Singapore, and there is preferential tax treatment for capital gains that are particularly important for the venture-capital industry (Jin, 2005, pp. 225-226).

In some jurisdictions, almost any income directly or indirectly generated in the international financial services industry may be the subject of tax privileges. In addition there are subsidies and direct government expenditures on regulation, training, construction, and pertinent facilities and services that provide cash and in-kind benefits for that industry. These lower its costs and help meet its infrastructure requirements.

An additional tax expenditure is due to the loss of seignorage that is associated with currency substitution being facilitated by the operation of OFCs in countries that do not have a domestic currency of international standing. While the development of OFCs which operate almost exclusively in major international currencies could actually promote the seignorage earned on currencies with such standing (see Kaufman, 2000), the evidence is that seignorage is lost from currency substitution against lesser currencies in open capital markets. In Hong Kong, for instanced, over 50 percent of banking business was in foreign currencies before use of the RMB started to spread (Huang, 2005, p. 195).

To flesh out the argument about seignorage effects: For large advanced countries with an international currency having an IFSC may attract more foreign business to that currency, but "significant seignorage gains do not appear automatically from being an IFC" (Kaufman, 2000, p. 9). For small countries without such a widely-used currency, significant seignorage losses, rather than small gains, are likely to be associated with being an IFSC or host to OFC operations. In those countries that are often without a credible currency of stable purchasing power over internationally traded goods, risk reduction through internationalization and currency substitution has tended to shrink the size of the onshore financial sector and of its domestic-currency component (see Bossone, Honohan, and Long, 2002, p. 120). The size of the inflation tax base is diminished and the disincentive to inflate is strengthened by (the threat of) currency substitution.

Hence considering tax preferences, subsidies, lower seignorage revenue, and government industry-development expenditures together, IFCs and OFCs are not likely to make a direct positive fiscal contribution to the countries that compete for them by market and nonmarket means. This raises the question of what else makes having such centers attractive for certain jurisdictions.

IV. Efficiency Criteria for IFSCs

Two aspects of efficiency are commonly distinguished. Macro-level efficiency of the financial system relates to the efficient transfer between surplus and deficit units, or lenders and borrowers, savers and investors, both within and between countries at low cost and with minimal risk of a major financial crisis. OFCs are not designed to arrange for net capital exports by the country in which they are domiciled because nonresidents account for the bulk of both their sources and uses of funds. Nevertheless, an OFC can have substantial net flow balances with any of the foreign countries whose residents are their clients: National balances with the OFC have to net out only for rest of world (ROW) combined.

If there is a substantial leakage from funds raised from nonresidents into the domestic financial system, known as *out-in* by its sources and uses, the regulatory and reserve standards applied onshore will in fact be no higher than those applied offshore, exchange and maturity mismatches may intensify, and domestic monetary policy my be undermined.[2] Fragility may rise because banks which operate in branch form in the offshore sector may not be required to hold capital and hence are not subject to minimum capital ratio requirements or to capital-based limits on large exposures (Huang, 2005, p. 204). Add the increased probability of supervision failures in complex networks of financial relationships and the result is that “some offshore centers have magnified any financial problems in their countries” (Kaufman, 2000, p. 6).

If a substantial leakage develops in the opposite direction, *in-out*, there may be sudden credit contraction and asset deflation associated with capital flight. On the other hand, to the extent IFSC activities are not segregated from those of internal banking, as in Hong Kong, net capital exports by Hong Kong residents could safely be intermediated by their acquiring direct or indirect claims on ROW by taking a position in their resident IFSC. Whether having a large

IFSC sector that is closely connected with the local economy increases the correlation of that location's shocks to GDP with the world business cycle, thereby increasing systematic risk, is debatable. What appears clear is that business-cycle synchronization among Asian countries in the 1990s can at least partially be explained by synchronization of net capital flows and the ensuing boom-bust cycles after financial market liberalization (Ito, Park, Wang, 2005, p. 5). Particularly under conditions of high leverage, greater fragility and risk could be associated with the increased macroeconomic exposure to the flow and ebb of international capital flows which IFSCs and offshore financial activity could bring. What is less clear is whether any possible cure, such as re-imposition of capital controls, is better for emerging-market countries than the disease of "sudden stops" and temporary reversals of capital flows that these countries can outgrow by achieving a higher level of financial development, greater market depth, and resilience.

To the extent certain IFSCs function as market-makers in their region to the world, their microeconomic efficiency in performing this function could be analyzed by the liquidity, volatility, and relative absence of price anomalies or "bubbles" in their regional securities market. Liu and Yang (2005) have applied this approach to evaluate the microeconomic efficiency of the Shanghai market, giving it low marks on all these grounds. They found that, in that market, systematic risk is high as stocks show pronounced co-movement with a "political" factor. Price/earnings ratios are excessive, volatile and bubble-prone in their view. They also find positive excess returns for small firms.[3] On the other hand, bid-ask spreads are low compared with those in Hong Kong. These factors by and large are not propitious for growing an offshore market, and past forays by major mainland Chinese banks into the offshore business in Shanghai-Pudong reportedly have not been profitable.

Instead of functioning as market makers in their region's securities to the world, IFSCs conversely can provide risk reduction through internationalization of the portfolios of domestic and foreign investors. Bossone, Honohan and Long (2005, pp. 120-121) judge that risk reduction possibilities opened up by international financial integration are exploited more by nonfinancial than by domestic financial institutions. It this is so, foreign financial institutions established either in the IFSCs and OFCs of a country or providing their services cross-border without a physical presence there, might have to be relied upon to achieve adequate international portfolio diversification.

V. The Outlook and Future Location for OFCs and IFSCs

As Tschoegl (2000, p. 9) has noted, simple considerations of the cost of labor, land, and capital tells us little about the location of financial centers. Instead, international politics, domestic political stability and peace, suitable domestic regulation, the development of communications and aviation networks and the location of cities have all combined to favor some places and disfavor others. For instance, between the two World Wars, Shanghai was the premier financial center for Asia, and Hong Kong's rise to prominence owes much to the disabling of this once dominant financial center in 1949. When economics rather than politics is critical to the choice of location, natural advantages and then agglomeration effects and scale economies may be involved. There is, of course, a link from agglomeration back to politics because once an IFC has acquired economic importance in a particular location, its interests, ably represented, and the government's desire to protect and promote the IFSC's reputation and business will also assume corresponding political weight.

Crowded cities with limited land area, such as Hong Kong, may welcome an environmentally clean service industry that requires only low levels of material and utility inputs and relatively little office space or plant and heavy equipment. Furthermore, the industry's disproportionate reliance on ICT infrastructure and services and on systems for extensive training of a skilled workforce contributes to the development of quasi-public goods that can be used at very low cost by others without requiring costly investments in additional capacity. Additional benefits of concentration in one place that are commonly mentioned include direct opportunities for socializing, exchanging information, and building trust among the finance professionals residing there and having the inside track in a large specialized job market. Tschoegl (2000) thus believes that the communications revolution that has minimized the economic significance of distance or *space* has not equally diminished the importance of *place*. He dismisses the widely-held thesis of "the end of geography" such as that reflected in Kaufman (2000, p. 9) arguing that acceleration in advances in telecommunications and computer technology in recent years is likely to further reduce the need for physical and permanent IFSCs.

Blommestein (2006) has discerned two opposing tendencies at work. Having global communications available at negligible cost indeed has made some lines of the financial service business entirely footloose in that it has no attachment to place. Rather, where it happens to take place is dictated solely by current cost considerations. On the other hand high-value added financial services have to address increasingly complex and long-horizon financial management tasks in close and intimate collaboration with clients. These clients require frequent personal, though not necessarily physical, contact and almost instant, practically in-house, availability. Hence footloose international financial services and sticky such services that cling to established relationships between IFSCs and their individually distinctive clients will co-exist.

Although Blommestein thought about the future of banking and not of IFSCs per se, his perspective is valuable for gauging the outlook for the latter, and what aspects of their business remains reasonably secure and potentially growing. His main thesis is that the product-driven financial supermarket model and the bancassurance model of providing "full in-house service" both need to be revised. Instead, a relationship-cum-market-based banking system is emerging in which specialized financial engineering development and applications for clients and the integration of products and services from outside suppliers play a greater role than before. With this open architecture, the share of fee income will grow. His supporting arguments can be summarized as follows:

- Credit scoring and online loan processing, loan securitization, and other ICT advances have eroded banks' traditional informational advantages in relationship banking. The scope of offshore banking activities expands as financial institutions can act less locally and more globally as local knowledge becomes more public and accessible from distant locations. In addition, lower costs for the creation, processing, and co-ordination of information have led to the strategic decision to outsource and offshore production and distribution activities.
- The shift in demand away from bank deposits toward debt and equity securities in some bank-packaged, bank-managed or otherwise intermediated form may favor offshore banking by making its cost of funds as low as that of onshore banks even without the assist of tax considerations. The strong link to capital markets in the new hybrid-type (relationship-cum-market) banking system may work in the same direction of making offshore and onshore banking products similar and subject increasingly to the same international regulatory and disclosure standards.
- However, as individuals are obliged to take more responsibility for their life-cycle decisions (education, work, savings, health insurance, retirement, estate planning), banks are called upon to develop a new form of life-cycle relationship banking and financial advising and assist with risk management. A physical presence and face-to-face contact still may be necessary to develop this long-term relationship and to build reputation and trust with clients.
- Economies of scale have turned out to be more important than economies of scope: Full – service financial groups of the bancassurance mode will be replaced by highly adaptable but focused groups offering a more limited range of particular core services, while non-core business if being outsourced, or run or pooled through joint ventures and partnerships. Even some large monolines have developed in segments such as securities processing and retail. On the other hand, there are incremental diversification benefits from mergers between banks and life insurance, and even more P & C insurance, companies so that scale economies and diversification benefits both drive M &As.

Hence while global sourcing will affect many individual and fairly routine financial service products, there is still the need to configure and co-ordinate this supply chain and then to integrate it into customized service delivery and long-term management for particular clients. Such enduring relationships are not made entirely in the thin air of e-space but require a convenient time and place to flourish. From a business development perspective the next question, of course, is what a location can do to make itself more convenient to clients than actually or potentially competing locations. For planning such steps concretely, the check list that is Table 1 provides at most some general directions to areas which might be strengthened.

Table 1: Requirements for Successful OFCs and IFSCs

A. Macroeconomic Prerequisites

A-1. Free international capital flows with all (for IFSCs) or at least special zones (for OFCs) of a country, and remote access from and to its foreign suppliers and clients
A-2. Stable exchange rates, low inflation, and freedom of currency substitution
A-3. Fiscal sustainability
A-4. Domestic tranquility, labor peace, and low levels of crime, fraud, and corruption and of business in furtherance of financial and other crimes or tax evasion

B. Physical and Institutional Infrastructure Requirements

B-1. Excellent ICT capabilities and public provision of accurate and readily accessible financial information and ratings; appropriate use of privacy safeguards
B-2. Advanced listing and exchange systems, efficient OTC and organized-exchange trading platforms and/or trading privileges on foreign exchanges
B-3. Efficient settlement procedures for payments and for trades in stock, bond, and derivatives markets that are up to international standards
B-4. A strong legal system, including property rights, contract enforcement, functioning court system, bankruptcy processes, and international accounting and auditing rules

C. Meeting Human Capital Requirements

C-1. Availability of well-educated and sophisticated bankers and their regulators/ supervisors and of analytical and managerial support staff critical for financial services
C-2. A favorable living environment and free entry for expatriates employed in the financial-service sector that enhances their availability and lowers their costs
C-3. A large talent pool and widespread competence in English

D. Industry Prerequisites

D-1. Economically strong and credible financial institutions with free foreign entry
D-2. A large complements of other financial businesses and of those who serve them
D-3. Minimum bank and securities regulation except prudential
D-4. A critical mass of financial activity to achieve economies of scale and scope
D-5. A high degree of efficiency by international standards in financial trading, intermediation and settlements, price discovery and underwriting

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Endnotes

[1] Throughout we are not concerned with OFCs that are merely booking centers that provide a legal place of record for transactions that actually take place elsewhere. Tschoegl (2000, p.5) explains the terminology distinguishing between functional OFCs with substantial value-added activities and pure booking centers or "brass-plate" OFCs supporting concealment activities. Some of the latter types of centers are identified in McCann (2006, pp. 449-450).
[2] Kaufman (2000, p. 6) relates that fully 60 percent of the $50 billion in loans made by the ostensibly "offshore" Bangkok International Banking Facility (BIBF) in the year before the East-Asian crisis that started in 1987 were "out-in" transactions used to finance domestic firms.
[3] "Size" however is a "priced factor" also in the United States, with "small" stocks having higher average returns than other stocks. See Cochrane (2005), p. 16.